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Latin America's underperformance

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Abstract:
The peso crisis was a wake-up call for Latin America. Reformist political leaders realize their support will erode if the economies of the regions do not turn around. But building robust economies requires deeper reforms, at a time when the people suffer from acute reform fatigue. For rapid growth with rising real wages, export growth and value added to exports must be higher. To foster these, Latin America must address long-neglected weaknesses with a next generation of reforms in education, infrastructure, banking and the civil service.

Full Text:

THE SHORT FUSE OF REFORM

IN THE LAST few years Latin American economies have undergone a remarkable transformation. Nations that sneered at the market system and pursued protectionist policies have suddenly embraced structural reforms aimed at stabilizing their economies, deregulating business practices, and becoming integrated with the rest of the world. After the Mexican peso crisis of December 1994, many observers predicted this process would end or, in some nations, be reversed. Their prediction proved false. Perhaps surprisingly, the reform effort continues-albeit at a different pace-in most countries. Now it appears that the Mexican crisis was a wake-up call for the region. Most political leaders realize that the reform process must intensify in order to build truly robust economies.

It is unclear, however, whether more rapid reform will be politically feasible. After almost a decade of reform, the region has little to show in improved economic performance and social conditions. Poverty has not been reduced. Growth has been modest at best. In many countries wages have stagnated and job creation has been sluggish. The reining in of inflation has been one of the few commendable accomplishments.

Until recently the Latin American population had given remarkable support to the reform process, rewarding political leaders who tackled their countries' perennial economic problems. The reelection of President Carlos Saul Menem in Argentina and the election of President Fernando Henrique Cardoso in Brazil have been perhaps the best examples. It is doubtful, however, that this support will last without faster growth and higher wages. For how long will the population be willing to make sacrifices? Is it realistic to ask the public to continue to back politicians who request patience while they are unable to deliver improved economic conditions? An increasing number of people are disillusioned, and there is a slowly growing sense of reform skepticism. The support for Abdala Bucaram's anti-reform platform in his election as president of Ecuador, the declining approval ratings of President Cardoso and President Alberto Fujimori in Peru, the general discontent in Argentina, the rejection of the reform program in Mexico by PRI members of Congress, and the violent demonstrations in Paraguay reflect increasing disappointment with the reform process. These events have shown that the Chiapas rebellion in Mexico may not have been an isolated incident, but rather the first sign of deep and growing dissatisfaction in Latin America.

In democracies, the durability of market-oriented reforms depends on the extent to which voters support the reformist government. The public generally supports governments that deliver solid economic performance. But under some circumstances, voters will back reformist governments even if the economy underperforms. What is important to realize, however, is that such backing is likely to be temporary. If the economy does not undergo a turnaround, voters will desert a reformist incumbent.

This dynamic suggests that unless growth accelerates, real wages increase, and unemployment declines, political support for Latin American reformist governments will erode. The prospects for faster growth and higher real wages depend on many factors, especially the Latin American countries' ability to increase exports. Rapid growth with rising real wages will require both higher export growth and an increase in the value-added content of the region's exports. Achieving this upgraded export growth is the region's fundamental challenge.

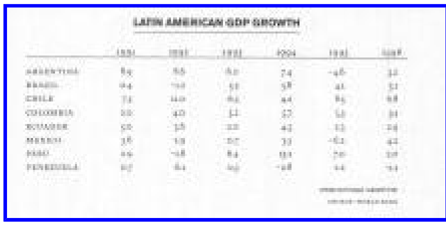
MOVING ON UP

DURING THE first half of the i99os, most Latin American economies underperformed. Between 1991 and 1996, GDP in Latin America and the Caribbean grew at modest rates, 3.1 percent on average. On the positive side, inflation continued to decline, reaching 19 percent in 1996, compared to more than zoo percent in 1991. And, after a rapid increase in the early 199os, the region's current account deficit fell to just 2 percent of GDP in 1996. During this period, however, the region experienced uneven economic development. Chile, El Salvador, and Peru grew at high per capita rates while managing to maintain inflation, while Mexico and Nicaragua had no growth.

The region's economic growth is disappointing in three ways. It is much lower than the region's historical average of 6 percent from 1965 to 1980; it is significantly lower than East Asian growth rates, which have become the benchmark; and it is far below the minimum rate of growth required to reduce poverty3.4 percent annually, according to the World Bank.

Latin America's performance has also been disappointing from a social perspective. In most countries, social conditions, particularly poverty, have not improved. In several countries, unemployment has increased sharply, raising the question of whether these market-oriented economies will create jobs fast enough to absorb a growing labor supply. In 1996, growth increased to an average of 3.1 percent in the region, and for 1997 it is expected to climb to 4 percent. Although this recovery would be a significant improvement over the modest performance of 1995, it is insufficient for the long term. In spite of this recovery, 1996 was another year of underperformance for Latin America.

Abundant evidence suggests that countries with an open economy grow faster than those that restrict international trade. A rule in economics suggests that in a small, open economy the rate of GDP growth will be approximately half that of exports. During the initial years of reform in Latin America, exports did indeed grow faster than in the past. In most cases, however, this trend is changing. The U.N. Economic Commission for Latin America has reported that, excluding Mexico, the region's export volume grew by only 3.6 percent in 1995. Moreover, in some of the largest countries like Brazil, Colombia, and Peru, export volume continued to grow at modest rates during 1996. If the region is to achieve faster growth, exports must pick up significantly.



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LATIN AMERICAN GDP GROWTH

What a country exports is almost as important as the pace at which exports expand. Countries that are active in international trade and export high-value-added goodsgoods whose production requires relatively high volumes of capital, sophisticated technologies, and skilled labor-have high real wages. Countries that export basic goods, on the other hand, have lower real wages. It is therefore possible to increase a country's real wages by changing its export pool.

Sweden's economic development illustrates this relationship between real wages and export bundles. In 1958 Sweden exported only natural resources, mostly forestry goods. By 1988 Sweden had significantly increased its investment in physical and human capital. As a result, in addition to forestry goods, its net exports included a high volume of capital-intensive manufactures and machinery. The shift in trade toward manufactured exports resulted in significant increases in Swedish real wages.

Almost a decade after the initiation of market-oriented reforms, most Latin American countries continue to export mostly resourcebased products with low value added. This situation contrasts sharply with that of China and India, which have rapidly upgraded their export mix and captured a growing share of the light manufactured export market. A key challenge for Latin American policymakers, then, is how to increase net exports of higher-value-added manufactures without imposing trade barriers or distorting the market system.

The solution has three parts. First, countries should accumulate capital-both physical and human-through higher investment and improving their education systems. This, in turn, will require implementating a new generation of reforms. Second, countries should increase their share of the high-value-added export market. This is not an easy task. The pace at which the world economy-and especially the richer countries-can absorb imports of manufactured goods is limited. Furthermore, competition among developing countries is stiff. Third, sustained export expansion requires exchange rates that are realistic.

THE NEXT GENERATION OF REFORM

MOVING uP the export value-added ladder and accelerating growth will require significantly increasing the rate of investment. The World Bank's World Development Report 1996 reports that

Latin America's aggregate investment was 20 percent of GDP in 1993, compared with 36 percent in East Asia. In order to increase investment, the region must face two enormous challenges: increasing domestic savings from their current anemic levels and attracting more foreign direct investment.

Latin America saved an average of 19 percent of its GDP in both 198o and 1994. That figure contrasts sharply with fast-growing regions that save up to 35 percent of GDP. Most policymakers now recognize that raising domestic savings is essential. President Ernesto Zedillo has made it the primary goal of Mexico's development plan. Acknowledging the importance of savings represents great progress relative to the early 199os, when most regional analysts were oblivious to the problem. The most direct and effective way to raise aggregate domestic savings is to increase public sector savings. With few exceptions, however, fiscal policy remains lackadaisical, and the public sector contribution to savings remains low. Brazil is perhaps the clearest example of this problem. Despite success on the inflationary front, the country continues to have a budget deficit near five percent of GDP. Latin America's public savings have typically been on the order of one to two percent of GDP, much lower than in East Asia, where public savings have averaged around eight percent. New fiscal adjustments, especially the reduction of inequitable entitlement programs, corruption, and waste, must be implemented to increase public savings.

Reform of the insolvent pay-as-you-go social security systems provides an important mechanism for raising domestic savings. These reforms, recently undertaken by seven Latin American countries, recognize and reduce unfunded liabilities of the old system. This by itself results in an increase in public savings since it forces government to truly finance these liabilities. Replacing a government-run social security system with private capitalization also increases private savings. Strengthening domestic capital markets, lowering taxes on corporate and personal savings, and, in particular, creating a safe and efficient banking sector will also encourage private savings.

In some countries, social security reform has run into political opposition, while in others, new systems have serious shortcomings. For example, the Brazilian Congress, after much debate, passed a basic reform that falls considerably short of what is needed to ease the fiscal burden. Uruguay has enacted a hybrid system that restricts the role of the private sector and maintains unfunded liabilities at more than loo percent of GDP. Mexico's reform has a number of provisions that are likely to reduce its effectiveness, including voluntary transfer to the new system after retirement and a requirement to channel contributions through the government social security agency.

Foreign direct investment is another way to increase capital accumulation. In 1995, partly because of the Mexican crisis, foreign direct investment in Latin America declined. Even in 1994, when it peaked, foreign investment in the region totaled only 1.4 percent of GNP. In East Asia, by contrast, foreign investment has surpassed 3.2 percent of GNP in every year since 1993. This disparity, in spite of the market-oriented reforms, results from the impression that long-term investment rules remain unstable in Latin America. Only two Latin American countries-Chile and Colombia-have been granted investment-grade ratings by international rating agencies.

The next few years will bring tremendous global competition for foreign investment. Latin America will have to compete with East Asia and Eastern Europe for foreign investors. The recent relaxation of restrictions on foreign ownership in South Korea is likely to result in massive flows of investment into that country. If the Indian government continues to support reform, it will be rewarded with more foreign investment. The consolidation of reform in Eastern Europe will attract further support. Latin American countries have their work cut out for them.

In order to compete successfully with other emerging economies, Latin American countries should implement a number of measures aimed at reducing country risk and improving their investment ratings. Without investment-grade ratings by international agencies such as Standard & Poor's and Moody's, it will be difficult for Latin American countries to attract significant foreign investment. Reducing country risk will require new institutions that provide stability. Such changes are part of what have been called second-generation reforms, and include the modernization of labor legislation and the judiciary.

State institutions should reduce transaction costs. That is, they should foster an environment in which individuals are confident enough to devote their time to productive activities, rather than to defending their property and lobbying for bureaucratic favors. State institutions should protect broadly defined property rights, enforce contracts, and provide an efficient system of conflict resolution. This setting requires not only the traditional separation of constitutional powers, but also independent and professionally run regulatory bodies. Even after years of reform, Latin America falls considerably short of that ideal. Conflict resolution mechanisms are primitive, the judiciary is inefficient and corrupt, and property rights-especially the rights of minority stakeholders-are systematically violated. As a result, in most countries people spend significant resources in unproductive ways. Second-generation reforms should aim to maintain macroeconomic stability through truly independent central banks, impose budget restraints on subnational governments, and create a modern national civil service.

Little is known about the process leading to massive institutional change. This process may generate frustration and, at times, disenchantment. But it is important that the regional leadership recognize that without these reforms Latin America will lose the race to attract foreign investment.

BACK TO BASICS

ACHIEVING SUSTAINED growth with increasing wages will require improving the quality of education. Latin American children have two fewer years of formal education than children in other regions at a comparable stage of development. A staggering 30 percent of students in primary school repeat grades, and students spend close to half their time receiving instruction on mechanical exercises. Students in public elementary schools get an average of 8oo hours of instruction a year-and as little as 3oo hours in rural areas-compared with approximately 1,zoo hours in rapidly growing countries and advanced nations. The problem is not lack of resources. Public sector spending on education is 3.7 percent of GDP in Latin America, versus 3.4 percent in East Asia. Yet the quality of Latin American education is among the poorest in the world. Standardized tests indicate that Latin American children rank at the bottom of international scales.

Once again Chile has become a pioneer in the Latin American region by tackling one of economic development's most difficult problems. In June 1996, Chile announced a major initiative to address the country's educational system. The project's goals are increasing productivity, reducing inequality, and assuring the sustainability of Chile's so-called economic miracle. The education reform project calls for increased teacher accountability and an end to two shifts in public schools. Instruction time will increase by one-third. Once the reform is completed, Chilean schoolchildren will have as many instruction hours as children in East Asia. The reform will affect 9,000 public schools at a significant cost-about 3 percent of current government expenditures.

GETTING TO MARKET

ONE OF China's most impressive recent achievements is its increase in export market share, especially of basic manufactures. In the years to come Latin American countries must emulate China's success and capture a larger share of the world market, especially in advanced countries.

Geography can play a role in accessing large markets. Simply put, distance matters. Countries that are close to large marketssuch as the United States, European Union, and Japan-have a clear advantage in gaining market share. For example, Mexico is blessed by its geographic proximity to the United States. Countries that are not well positioned must take positive steps to increase their economic proximity to large markets. Australia, New Zealand, Taiwan, and Singapore have done this successfully. Improving the quality of infrastructure-especially roads, telecommunications, and ports-is an effective way for a country to compensate for poor geographic proximity.

International comparisons reveal that export-driven growth cannot occur with third-class infrastructure. During most of the 198os and the first half of the 1990s, infrastructure investment was neglected in Latin America. The region has inadequate power generation, roads, water supply, and telecommunications. Telephone calls take a long time to be completed-when they are completed at all; a large number of roads are in deplorable condition, adding substantial costs to transportation; and power outages are common occurrences in many areas. The World Bank has calculated that $6o billion per year in infrastructure investment would be required through the year 2000 to make up for these deficiencies. The infrastructure investment required during the rest of the decade represents about 4.5 percent of regional GDP and is larger than the combined annual regional lending of the World Bank and InterAmerican Development Bank. The bulk of infrastructure investment will have to come from the private sector, both domestic and foreign.

Infrastructure requires large investments whose returns are realized over many years. These returns can be lowered by unwise government decisions, such as the imposition of new tariffs or unfair competition from state-owned enterprises. Large private investments in infrastructure will be made only if a government can credibly commit itself to respecting the regulations governing tariffs and market access. An efficient and independent judiciary is also necessary to ensure contracts are respected and to resolve conflicts at low cost. In many Latin American countries the judicial system is antiquated. A 1996 study by the independent think tank Fundacion de Investigaciones Economicas Latinoamericanas in Buenos Aires suggests that in Argentina the administration of justice is more inefficient and costly than in any other country in the Western Hemisphere. Trials are exceedingly long, imposing enormous costs on the private sector.

When building its infrastructure, Latin America will again face stiff competition from Asia and Eastern Europe. To remain competitive, Asia will require an estimated $7 trillion in infrastructure investment in the next 25 years, of which at least $1.5 trillion will have to be invested in the next ten years. India will need $200 billion in the next decade to upgrade its infrastructure to minimal levels. The competition will be hard. But if Latin America's second-generation reforms move forward, the rewards promise to be substantial.

TODAY AND TOMORROW

MOST OF the policies discussed above will take years to bear fruit. Reform fatigue, however, has already arrived, and the electorate may not have the patience to wait. What can be done now? Are there policies that could accelerate growth in the short run? The options, unfortunately, are limited. Rapid and sustainable growth will take place only if economic fundamentals-investment, education, longterm foreign financing-are strong. Macroeconomic management, however, can make a difference in the short run. Countries that value their currencies realistically and reduce deficits and real interest rates will experience a sustained recovery. These policies may allow countries to regain-and in some cases even surpass-the export growth of the early 1990s.

Countries that rely on currency overvaluation to artificially reduce inflation are bound to experience speculative attacks that will hurt growth. Unfortunately, using the exchange rate to make short-run progress on inflation can be seductive. This is what Brazil has done during the last i8 months, and unless it takes corrective measures, it is bound to face an economic crisis. Ecuador, under the leadership of the populist Bucaram, is also embarking on an overvaluation adventure by adopting a pegged exchange rate in the face of major fiscal imbalances. Mexico, once again, seems to be forgetting the lessons of history by insisting on appreciating real exchange rates and relying on short-term foreign capital.

Policies aimed at strengthening banks may pay off. The Mexican peso crisis demonstrated that a weak banking sector will magnify external shocks, heighten uncertainty, and reduce investment. Measures that ensure that banks maintain sound lending practices are likely to enhance public confidence and help increase savings. Sound banks will also encourage longer-term foreign financing. Policies geared to reducing tax evasion and corruption are likely to boost short-term growth. Such policies, however, are no substitute for strengthening economic fundamentals.

Two years ago, at the Summit of the Americas conference in Miami, President Bill Clinton prematurely declared Latin America's market-oriented reforms a success. Despite tremendous progress in deregulating markets, privatizing state-owned enterprises, and taming inflation, there has been little improvement in social conditions. Almost a decade after the initiation of market-oriented reforms, most Latin American countries are caught in a trap: they must implement deep institutional reforms to reduce perceived country risk and achieve sustained growth. Many of these second-generation reforms, however, are politically difficult and unpopular.

Overcoming decades of government domination of the economy and inequality will require political courage. It is unclear in how many countries this courage will prevail. It is likely that we will soon see a two-, three-, or even four-speed Latin American economy. In some countries, like Chile, second-generation reforms will be undertaken rapidly; in others they will take a long time, and in still others they will not be implemented at all. Poles of prosperity and modernism and pockets of poverty and backwardness may soon mark Latin America's economic landscape.

[Author note]

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